No. 10088

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CONSOLIDATED ROYALTIES, INC., a corporation, and C. B. CALLAHAN,

Appellants,

vs.

HARRY ASHTON, Trustee of the Estate of DEEP HOLE DRILLING CORPORATION, Bankrupt, *et al.*,

Appellees.

APPELLANTS' REPLY BRIEF.

FLEMING & ROBBINS and
C. S. TINSMAN,
1121 Stock Exchange Building, Los Angeles,
Attorneys for Appellants.

Parker & Baird Company, Law Printers, Los Angeles

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APPELLANTS' REPLY BRIEF.

In the reply brief of Appellee, it is stated that Appellants have correctly stated the facts with certain exceptions. Appellants wish to point out that what are termed exceptions are merely additional facts and are not in fact exceptions to the facts already given, there being no intention on the part of Appellants to misstate any fact. Furthermore, it is stated on page 6 of Appellants' brief that Standard Oil Company accepted the division order and "royalties were paid to appellants through August, 1939," and on page 7 it is stated that "The debtor corporation gave appellants an option to acquire royalty interests in other wells."

Reply to Point 1.

Under Point 1 of the Argument, Appellee seeks to establish jurisdiction of the bankruptcy court to summarily deprive Appellants of their property and in this discussion apparently relies upon the fact that physical possession of the oil well was sufficient to give the bankruptcy court jurisdiction to subordinate Appellants' ownership of 12% of the oil to the rights of general creditors. Appellants submit that it is pointed out in the opening brief, on page 30, that the oil was purchased at the well by the Standard Oil Company and title passed to the purchaser upon delivery. [Tr. p. 27.] The irrevocable division order had been accepted and under Point III, in the case of *Taylor v. Odell,* 50 Adv. Cal. App. 158, it is shown that the money for the production was held in trust for plaintiffs.

Therefore, it is respectfully submitted that the bankrupt had no interest in Appellants' oil or in the proceeds thereof and if the bankrupt had no interest therein, certainly the bankruptcy court would not have jurisdiction to deprive Appellants of their property. The cases cited by Appellee are cases wherein the bankrupt had an interest in the property which it was sought to protect for the benefit of creditors. For example, in the case of *Street v. Pacific Indemnity Co.,* 61 Fed. (2d) 106, referred to by the Appellee, it was pointed out that the county held the money for the account of the bankrupt at the time the petition was filed and further it could not therefore be said that the bankrupt had no interest in the money. Certainly those are not facts applicable to our case.

Reply to Point 2.

As anticipated by Appellants, the order of the bankruptcy court is sought to be upheld, on the authority of *In re Lathrap,* 61 Fed. (2d) 37. Appellants contend this case is no longer the law and the facts of the *Lathrap* case have been distinguished in the opening brief. As additional authority for the right of the bankruptcy court to subordinate Appellants' ownership in the oil to the right of general creditors, Appellee cites the case of *Pepper v. Litton,* 308 U. S. 295. In this case, the claimant occupied a fiduciary relationship with the bankrupt and it was shown that he did not act in good faith in his dealings with that concern and had unfairly attempted to gain advantage over creditors. The reasoning applied to that decision has no application here. There was no finding of bad faith or inequitable conduct on the part of Appellants and there was none in fact. From an equitable standpoint, it would seem apparent from the facts of our case that creditors who continued to extend credit to the bankrupt, which eventually resulted in its bankruptcy, and with full knowledge of Appellants' ownership of 12% of the oil, should be prevented from making any claim to Appellants' oil and the proceeds thereof.

The other case relied upon by Appellee, to-wit, *Prudence Realization Corporation v. Geist,* is not authority for the point made. No inequitable conduct has been charged against Appellants in this case and Appellants are not "claimants". As a matter of fact, in that case the right

of Prudence corporation, who did have a claim against the bankrupt to participate equally with the other creditors, was upheld.

Furthermore, the cases so cited by Appellee involved claims against the bankrupt estate. Appellants in this matter are not establishing a claim against the estate, but on the contrary are seeking to protect from arbitrary confiscation their vested property rights in oil in which the bankrupt had conveyed all its interest and in and to the proceeds of the oil held for their benefit by the Standard Oil Company. Appellee apparently places some reliance upon the case of *Schiffman v. Richfield Oil Co.,* quoting dictum therefrom, which question it was expressly stated was not involved in that case. On the other hand, we have an express holding of the court in the case of *Spier v. Lang,* 4 Cal. (2d) 711, that a joint adventure had not been established which would make defendant liable for drilling costs.

Wherefore, Appellants respectfully submit that in view of the law of the state of California and other decisions cited by Appellants in their opening brief, the *Lathrap* decision should be expressly overruled in so far as it subordinates the interest and ownership of overriding royalty holders in oil to the claims of general creditors and that the decision and order of the bankruptcy court should be reversed.

Respectfully submitted,

FLEMING & ROBBINS and

C. S. TINSMAN,

By C. S. TINSMAN,

Attorneys for Appellants.

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Appellees.

BRIEF OF AMICUS CURIAE ON BEHALF OF THE APPELLANTS.

CHARLES Z. WALKER,
514 Farmers & Merchants Bank Building, Long Beach,
Amicus Curiae, on Behalf of Appellants.

Parker & Baird Company, Law Printers, Los Angeles

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BRIEF OF AMICUS CURIAE ON BEHALF OF THE APPELLANTS.

Preliminary Statement.

It is needless to restate the facts, as they are amply set forth in appellants' opening brief, and therefore we shall, as briefly as possible, state our contentions under the

SUMMARY OF ARGUMENT AND ARGUMENT.

Summary of Argument.

The Referee held that appellants were co-adventurers in a joint adventure with Deep Hole Drilling Corporation, and was sustained therein by the District Court except in a minor matter.

Great dissatisfaction in the legal profession has followed the holding of this court in *In re Lathrap,* 61 F. (2d) 37, on the question of what constitutes a joint adventure and who are joint adventurers. We submit that every assignee of a lessee's royalty is not necessarily a co-adventurer with the lessee. We believe that if this court examines the authorities hereinafter submitted on the question of joint adventure, it will not hesitate to declare that its holding in *In re Lathrap, supra,* is contrary to the law of California, and that the court will modify its views on the subject so as to make them conform to California law, and to that end we sincerely submit our

ARGUMENT.

POINT I.

The Purchaser of Overriding Royalties in a Producing Well Is Not, Ipso Facto, a Joint Adventurer With the Operator, and the Court Erred in Affirming Referee's Holding That Appellants Were Co-adventurers With Deep Hole Drilling Corporation.

Deep Hole Drilling Corporation, when it assigned to appellants 12% of its production from Well No. 1, was a going concern with a producing well producing at the rate of 400 barrels of oil a day. This is an important fact bearing on the question as to whether or not the Referee was justified in finding that the appellants were co-adventurers with Deep Hole Drilling Corporation in Deep Hole Well No. 1.

Adventure is defined by Webster as a mercantile or speculative enterprise of hazard, and consequently an adventurer is by the same token one who enters into a mercantile or speculative enterprise of hazard.

To hold that all purchasers of overriding oil royalties in a producing oil well, *ipso facto*, enter into a hazardous adventure, and to exclude the merchant who supplies his goods on credit in the same enterprise, from that category is unfair. There are many instances, of course, where backers of oil well operators are properly classified as co-adventurers with the operator, as in an unproven oil field, where the driller undertakes an original exploration and the backer pays the costs of drilling, for a large part of the profits. But to classify all purchasers of overriding royalties as co-adventurers in an oil well enterprise does violence to the definitions applied to real co-adventurers by the courts and textbook writers.

It will, we believe, be conceded, that in order to constitute a business arrangement a joint venture, that certain necessary elements must be present. Every joint venture must have the same elements as those of a partnership.

Spier v. Lang, 4 Cal. (2d) 711.

Section 2400 of the Civil Code of California declares the rule for the existence of a parnership. The relation of appellants to Deep Hole Drilling Corporation does not fit into a partnership relation, and by the same token it does not fit into the rules necessary to classify them co-adventurers.

Before citing authorities on the question let us analyze the decision in the *Lathrap* case. Its philosophy is predicated on the proposition that all percent holders in oil wells are co-adventurers with the operating lessee. What is said in the opinion as to the character of the certificates issued by the bankrupt lessee in that case, is of no moment now because the Supreme Court of California finally settled the question of what an overriding royalty is, in *La Laguna Rancho Company v. Dodge,* 18 A. C. 107; 114 Pac. (2d) 351.

It is therefore immaterial, for the purposes of a decision in the instant case, to consider any problem other than the fundamental question as to whether appellants were, in the face of the record here, and the law of the courts of last resort of California, co-adventurers with the bankrupt lessee, Deep Hole Drilling Corporation.

This legal question naturally arises: Upon what hypothesis did this court label the percent holders in *In re Lathrap* as co-adventurers with the driller?

On page 43 of the *Lathrap* case it is said:

"Since percent certificates are comparatively a recent device, we must expect to find that cases more or less squarely in point have been decided only in the last few years. The first federal decision involving facts on all fours with those of the case at bar was United States & Mexican Oil Co. v. Keystone Auto Gas & Oil Service Co. (D. C. Pa.), 19 F. (2d) 624, 625. In some respects that decision was based on facts that were more favorable to the certificate holders than those in the instant case. There the certificates themselves contained the following provision: 'To provide funds hereinbefore mentioned from the receipts of said station there shall be set aside in a bank one cent on each gallon of gasoline sold, and 5 percent on all merchandise sold by said station, and the fund thus created shall be distributed every month among the registered holders of these certificates in said stations as their interest may appear.' (Italics ours.) It will thus be seen that in the above case at least an attempt was made definitely to create what might be termed a trust fund for the benefit of the percent holders. Yet in the face of such specific attempt, Judge Schoonmaker said, at page 626 of the reported opinion in 19 F. (2d):

"On general principles of public policy, we believe that this contract is void as against the claims of general creditors. To permit corporations, by means of certificates of this kind, to appropriate corporate assets to certain classes of creditors or shareholders, whatever they may be, would be an absolute fraud upon the general creditors of the corporations concerned, and would permit the creation of a special type of preferred creditors not contemplated by law. If enforceable at all, this contract should only be enforced as against the stockholders of the company,

and not against the rights of creditors who have dealt with the corporation in the ordinary way. To give validity to such a contract would be to establish a legal vehicle for corporation fraud and illegal preference of creditors. These certificate holders cannot claim any part of the corporate funds to the detriment of general creditors."

"There is no special equity vested in these certificate holders that should be protected. There is no special equity founded on the relation of these certificate holders to the funds on deposit in the several banks in question that should be protected. The fund in bank bears no special relationship to their money contributions to the company. The money in bank came from the sale of general assets of the company —*i. e.,* gasoline and other merchandise—in the regular and ordinary course of business. To impress this fund with a special trust in favor of these certificate holders would be wrong and a fraud on general creditors."

"These certificates evidence an attempt on the part of the defendant to create a novel type of stock ownership, which would be superior in its claim to corporate assets over that of the corporate creditors. There is no equity in their claim or position, and there is no statutory authorization to create such a class of preferred stockholders or creditors, whatever you may call them. The funds in bank were not reduced to their possession; they have no claim on it."

With due respect to this court and to the learned author of the opinion of *In re Lathrap,* we most sincerely submit that there is no legal analogy between a purchaser of overriding royalties in a finished and producing oil well and a stockholder of a corporation or a partner or a co-adventurer as the same are defined by law.

POINT II.

The Court Erred in Subordinating Appellants' Interest in the Oil and the Proceeds Thereof to the Claims of Creditors.

It is unfortunate that, in the *Lathrap* case, counsel for appellants referred to them as investors. It was an incorrect designation and the court apparently adopted the same designation from *In re Hicks-Fuller Co.*, 9 Fed. (2d) 492, where it is said that appellants were merely preferred stockholders and that their rights would be subject to the debts of the corporation, including general creditors. This court held to the same effect in *In re Lathrap.*

This court also adopted from *In re Hicks-Fuller Co., supra,* the following general classification:

> "It is not necessary, however, for us to regard the appellants as technically in the nature of joint adventurers or stockholders, in order to determine that their status is inferior to that of general creditors, who have dealt with the bankrupt in good faith and only for a normal profit."

Such general classification cannot be applied to appellants in the instant case. Why a halo should be pressed on the brow of a merchant, who sells oil well equipment even at a normal profit, at the expense of a royalty owner, is incomprehensible. There is no evidence of such a situation in the record here. In so far as the record shows appellants bought royalties, *not as investors in a wildcat, or unfinished oil well,* but in a producing property operated by a sound business enterprise which had few debts. We ask, therefore: Upon what evidence before the Referee were appellants subordinated to crditors of this bankrupt, who furnished equipment on credit, even

without evidence that the profits thereof were normal? All merchants who extend such credit take risks and gamble on the possible success of an oil enterprise. We sincerely believe that this court will modify the sweeping declaration of *In re Lathrap,* which holds that all percent holders in an oil well are co-adventurers with the lessee. Such question should be determined only by the facts of each case upon legal evidence of what profits, if any, the merchant expected to make when he extended credit to the driller and upon the value of the well and the return the production brought the royalty owner. A rule of reason should be applied to the facts of each case.

The Referee held that:

> "I am of the opinion that the claimants here are co-adventurers with the bankrupt in so far as Well No. 1 is concerned, and that the claims should be subordinated to the extent of claims of those who furnished supplies or other commodities for the completion of Well No. 1." [Tr. p. 55.]

No reason is stated for the Referee's opinion.

It is obvious that the ruling of the Referee and the finding based thereon was the result of this court's decision in *In re Lathrap,* and since it is our contention that said finding is not sustained by the record, in that there is no evidence that appellants were engaged in a joint adventure with Deep Hole Drilling Corporation, we submit the following points and authorities.

It is held that the necessary elements of a joint enterprise are, a community of interest in the object of the undertaking, an equal right to direct and govern the conduct of each other with respect thereto, the duty to share

in the losses, if any, and a close and even a fiduciary relationship between the parties.

Larson v. Lewis-Simas-Jones Co., 29 Cal. App. (2d) 83; 84 Pac. (2d) 613.

See, also:

Beck v. Cagle, 46 Cal. App. (2d) 152; 115 Pac. (2d) 613;

Ford & McNamara Inc. v. Wilson, 119 Cal. App. 475; 6 Pac. (2d) 996;

Lerner v. Sanderson, 126 Cal. App. 481; 14 Pac. (2d) 584.

In *Spier v. Lang,* 4 Cal. (2d) 711, a question arose in an oil well transaction as to whether the relationship between the contracting parties was that of a partnership or joint venture. The court held that the question was one primarily for the trial court to determine from all the facts and inferences to be drawn therefrom.

The court said (p. 716):

"The main reliance of the plaintiffs is on the provision of the contract that the defendants were to share in a division of the profits. But this feature of the agreement has long been held not to require a conclusion that a partnership relation existed where also there was no joint participation in the management and control of the business, and the proposed profit-sharing was contemplated only as compensation or interest for the use of the money advanced. (Vanderhurst v. De Witt, 95 Cal. 57, 62 (30 Pac. 20, L. R. A. 595); Coward v. Clanton, 122 Cal. 451, 454 (55 Pac. 147); Peoples Lumber Co. v. McIntyre & Peters, 179 Cal. 780 (178 Pac. 954); Martin v. Sharp & Fellows Contracting Co., 34 Cal. App. 584 (168 Pac. 373); Auditorium Co. v. Barsotti, 40 Cal.

App. 592 (181 Pac. 413); O. Krenz C. & B. Works, Inc., v. England, *supra;* Balck v. Brundige, 125 Cal. App. 641 (13 Pac. (2d) 999.) The foregoing conclusion and cited cases are in conformity with the definition of the partnership relation contained in the Civil Code (sec. 2400, Stats. 1929, p. 1898, formerly contained in sec. 2395), which includes as an essential element the joint participation in the conduct of the business. *The presence of the same element is necessary to constitute the parties joint adventurers.* (See, also, Martin v. Peyton, 246 N. Y. 213 (158 N. E. 77); Pierce v. McDonald, 168 App. Div. 47 (153 N. Y. Esch., 127 Okl. 275, 260 Pac. 755); Gille Hardware & Iron Co. v. Harrison, 89 Mo. App. 154; Cudahy Packing Co. v. Hibou, 92 Miss. 234 (46 So. 73, 18 L. R. A. (N. S.) 975).)" (Italics ours.)

The transaction between appellants and Deep Hole Drilling Corporation can only be tested by the contract between them, and it consists only of the royalty assignment. [Tr. pp. 38-42.] *It is utterly devoid of any of the elements necessary to constitute a partnership or joint venture.*

In view of the state of the law in California it is manifest that counsel for appellants in *In re Lathrap* failed to give due consideration to the importance of the question of what constituted a joint venture and attention of this court was not called to decisions of courts of last resort in California which laid down the essential elements necessary to constitute a joint venture, which were elements not present in the *Lathrap* case and are not present in the instant case.

In *Laugharn v. Bank of America*, 88 F. (2d) 551, this court held that a decision affecting interests created by an

oil and gas lease is a determination of rules of property which federal courts will follow when the state courts have so determined. It is said at page 553:

> "If previous decisions of this court, in the absence of state court decisions, established a rule of property, which was later changed by state statute, can it be argued that this court must follow previous decisions? If the law of the state is established either by statute or judicial decisions, this court must follow the law of property as determined by the highest state court. Therefore, we must and do overrule the prior decisions of this court in so far as they are inconsistent with the settled law of California as adjudged by the California courts. On this basis we hold the assignments in the instant case to be conveyances of an interest in real property, and not to be executory contracts."

By the same reason this court should not do less here than adopt the rule of law of the state courts and modify its decision in *In re Lathrap* on the question of joint venture for the reasons hereinabove suggested.

Conclusion.

We therefore most respectfully urge that this court modify its sweeping decision in *In re Lathrap,* declaring that all assignees of a lessee's interest in the production of an oil well are co-adventurers with the lessee, and adopt a rule in consonance with the law of California on the subject. This, of course, would require a reversal of the order and we sincerely trust that the court will so do.

Respectfully submitted,

CHARLES Z. WALKER,

Amicus Curiae, on Behalf of Appellants.